

## MONGOLIA

## Investment Opportunities Abound As Growth Soars

**BMI View:** Mongolia is set to become one of the fastest-growing economies in the world by 2011, as a result of its huge mineral deposits, favourable business environment, stable political conditions and proximity to expanding markets in Asia. Opportunities for investors will present themselves across asset classes and sectors, and we highlight infrastructure, real estate and banking as particularly attractive.

Our key views include:

- Growth will average 9.6% between 2010 and 2014, on the back of rapidly increasing mineral exports and foreign investment.
- Mongolia's close proximity to resource-hungry Asian markets (particularly China) should ensure that demand for Mongolian exports remains elevated.
- The political environment is stable, with a broad consensus among the main political parties towards economic liberalisation, which should ensure

investor confidence.

- This will be boosted by the country's favourable business environment, with the landmark Oyu Tolgoi deal signed back in October 2009 establishing a stable environment for companies to operate in.
- The influx of investment into the mining sector should spill over into the wider economy, resulting in rapid growth in a number of sectors.

We believe that the strong growth outlook will provide an array of oppor-

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## TURKMENISTAN

## Energy Sector To Fall Short In 2010

**BMI View:** Following Gazprom's decision to cut its imports of Turkmen gas by two-thirds this year, Turkmenistan's energy sector is set to underperform for a second year running. With gas exports having been a key driver of economic expansion in the past, we now highlight downside risks to our 8.5% growth forecast for 2010.

Russian energy firm **Gazprom** announced on April 16 that it would import 10.5bn cubic meters (bcm) of gas from Turkmenistan in 2010, only one-third of the 30bcm that Moscow had previously stated it would be will-

ing to purchase. This follows a similarly disappointing year in 2009 for the Turkmen gas sector, after Moscow stopped all gas imports from the Central Asian nation in April 2009. Russia

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## THIS MONTH'S TOP STORIES

### Ukraine: Foreign Policy Reorientation Now Complete

**BMI View:** The signing of two landmark bilateral agreements over longstanding and controversial energy and security issues by Ukraine and Russia on April 21 confirms our long-held view that the election of President Viktor Yanukovich would lead to a fundamental denouement in bilateral relations between the two countries. Going forward, we believe this ongoing rapprochement between the neighbouring states will continue to bode well for Ukraine's medium-term macroeconomic and political outlook, particularly if it results in a marked shift in investors' risk perceptions of the former Soviet state. That said, we are growing increasingly concerned that as a result of the improved terms of the gas supply contract, Ukrainian authorities will fail to take the necessary measures required to improve the competitiveness of the economy over the long term.

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### Inflationary Pressures To Mount In 2010

**BMI View:** With the Moldovan economy expected to return to positive growth in 2010, and with global commodity prices continuing to edge higher, domestic inflationary pressures will continue to build this year. That said, with domestic demand likely to be weaker than before the global economic crisis, we do not expect a return to double-digit rates of inflation.

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### Russia: Holding To Our Bullish Rouble Outlook

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### Uzbekistan: Reconciliation Reconsidered

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## REGIONAL INDICATORS

|  | 2008   | 2009e  | 2010f  | 2011f  |
|--|--------|--------|--------|--------|
| <b>CIS States Indicators</b>             |        |        |        |        |
| GDP, EURbn [1,3]                         | 2111.6 | 1713.4 | 2038.7 | 2426.6 |
| Real GDP growth, % [2,3]                 | 5.5    | -6.7   | 3.6    | 4.7    |
| Inflation, eop, % [2,3]                  | 15.3   | 11.4   | 9.2    | 9.0    |
| Exports, EURbn [1,3]                     | 712.0  | 460.4  | 544.0  | 642.8  |
| Imports, US\$bn [1,3]                    | 497.9  | 331.6  | 368.6  | 436.9  |
| Trade balance, EURbn [1,3]               | 214.2  | 128.9  | 175.4  | 205.9  |
| Current account, EURbn [1,3]             | 110.1  | 47.1   | 93.3   | 113.1  |
| Current account, % of regional GDP [1,3] | 5.2    | 2.8    | 4.6    | 4.7    |

Notes: e BMI estimates. f BMI forecasts. 1 Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine & Uzbekistan. Data correct when forecasts were published.; 2 Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine & Uzbekistan. Data correct when forecasts were published. Weighted by nominal GDP.; Sources: 3 BMI.

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tunities across several asset classes for investors looking to gain exposure to Mongolia.

### Oyu Tolgoi Agreement

The landmark agreement signed between the Mongolian government, Rio Tinto and Ivanhoe in October 2009 for the Oyu Tolgoi copper and gold mine has laid the groundwork for stable investment conditions in Mongolia over the long-term. As the table below shows, it not only covers the specific terms related to the Oyu Tolgoi mine, but also establishes a set of rights for international investors looking to invest in fixed assets in Mongolia, including the right to repatriate profits and sell products at market prices.

### Fixed Investments

Fixed investments will provide one of the best ways for investors to play the mining boom through the medium term, given the growth potential and the government's efforts to attract US\$25bn of new investment into the mining sector in the next five years.

We believe that the development, extraction and transport of these mineral deposits will necessitate massive investment across the economy, and highlight the following sectors as likely to present particular opportunities:

**Transport infrastructure:** This area is already creating headaches for mining companies operating in Mongolia, with the lack of a rail connection to China from the mineral deposit fields of particular concern. Several foreign firms, including **Leighton Asia**, **Russian Railways** and **Deutsche Bahn AG** have already signed deals to build railways, and we expect more to follow.

**Power:** Under the terms of the Oyu Tolgoi mining agreement, electricity imports will only be allowed for four years after the project's completion. With construction expected to be completed in 2013, and the mine likely to need large-scale power over the long term, significant new power capacity will need to be installed in the vicinity of the mine by 2017. With local firms unlikely to have the capacity or the skills to meet the demand, we believe that this will create a potential entry point for foreign power utilities.

**Real estate:** Korean and Japanese companies have already invested in residential

and commercial real estate in Ulan Bator, and we believe that significant scope for further development exists. The expansion of domestic firms, and the arrival of foreign ones, is likely to mean that demand for new office space is particularly high, while increased wealth among Mongolians should see demand for new houses and apartments rise.

**Banking sector:** Mongolia's banking sector has been among the worst affected in the CEE region by the global financial crisis, with non-performing loans spiking to more than 17% of the total, and the impact of the tough 2009-2010 winter on the rural community set to pose further risks. That said, mergers and IMF-led banking sector reform should put the banking sector on a more sustainable footing going forward, allowing it to benefit from the upcoming mining boom.

**Golomt Bank**, Mongolia's largest privately owned bank, plans to go public as early as 2012, with others likely to follow.

### Portfolio Investment

Portfolio investors should be able to secure large gains by increasing their exposure to Mongolian equities going forward. The Mongolian Stock Exchange (MSE) has significant upside potential in our view, thanks to its current limited market capitalisation (17.1% of GDP), the likelihood of a spate of new listings in the near future, and the probability that many existing listed companies will grow rapidly over the medium term.

### Mongolian Stock Exchange

The government plans to sell off a 20-30% stake in the MSE this year, probably to a major international bourse, in the hope that this would result in a transfer of operational knowledge and new technology to develop the MSE. **SouthGobi Energy Resources**, an international firm which operates the Ovoot Tolgoi coal mine (and is already listed in Hong Kong and Toronto), has already announced it plans to list on the MSE. The government has also announced plans to privatise coal mining companies **Baganuur** and **Shivee Ovoo**, while other major business groups including **MCS Group**, **Newcome Group**, **Bodi Group**, **Tavan Bogd Group** and **Monnis Group** are considered contenders to go public.

One of the most attractive investment opportunities for portfolio investors is likely to be presented by the planned international and domestic listings of government assets

## RISK SUMMARY

### POLITICAL RISK

#### Growth Story On Track

Mongolian President Tsakhia Elbegdorj announced on April 27 that the issuance and transfer of mineral exploration licenses has been suspended, until the government can pass stricter laws on mining investment. Public discussions will be held on the issue in June, although it is thought unlikely that existing permits will be affected. Going forward, while we acknowledge the ban as a risk to our outlook, we remain bullish on Mongolia's long-term growth potential.

Our short-term political risk rating is 74.0

### ECONOMIC RISK

#### Inflation Risks Mounting

Inflation reached 7.7% y-o-y in March, up from 4.5% in January, although down from 8.6% recorded in February. The rise in inflation seen through Q1 10 supports our view that the death of around 10% of Mongolia's livestock following a tough winter was likely to see inflation spike, given that food makes up 66% of the total consumer price basket. We see the potential for inflation to head higher in short term, although hold to our forecast for it to fall to 7.0% by end-year.

Our short-term economic risk rating is 41.9

### BUSINESS ENVIRONMENT

#### New Merger Announced

Australian listed **BKM Management** is to acquire Mongolia-based **SMG Oil & Gas** through an all-stock offer of 25mn shares at AUD0.01 (US\$0.009) per share. SMG is licensed to conduct exploration activities in the Baitag region next to China's Xinjiang state. The company's assets include Block 30, which covers 14,737sq km. SMG has been awarded a contract by the Mongolian government to undertake an oil exploration geological survey in Block 30, which is due for completion in June 2011.

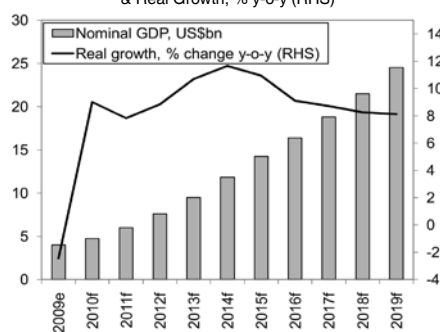
BMI's business environment rating is 47.0.

in the mining, power and infrastructure sectors. Prime Minister Batbold has announced plans to establish and sell shares in three major companies, consolidating the government's assets in key areas, and likely attracting significant new investment. The planned IPOs are:

- **Mongol Erdes** (Mongolian Minerals), consolidating the government's mining assets.
- **Mongol Erchim** (Mongolian Power), combining its power assets.
- **Mongol Ded Butets** (Mongolian Infrastructure) consolidating its infrastructure projects.

### Ready For Lift-Off

Mongolia – Nominal GDP, US\$bn (LHS)  
& Real Growth, % y-o-y (RHS)



Source: BMI

### Major Investors Set To Arrive

We believe that the arrival of major private equity funds and large investment banks is only a matter of time, creating the potential for significant new investment. Although this is unlikely to happen in 2010, we believe that the rapid growth over the past few

years, as well as the excellent prospects for increased economic activity going forward, will see Mongolia become increasingly prevalent on institutional investors' radar screens through the medium term.

Mongolia's potential has already seen a number of smaller private equity firms arrive, among them **Eurasia Capital Management** and **Firebird Management LLC**, with investments in mining, property, telecoms and locally-listed stocks. Firebird launched a Mongolia Fund in March, dedicated to local Mongolian equities. This has come concomitant with the development of the financial services industry, with the gradual emergence of western-style investment banks, advisors, research and brokerage houses. Although this is still in a nascent stage of development, we believe that the fact that financial intermediation was the second fastest growing sector of the economy in nominal terms between 2005 and 2008 indicates that the market is maturing.

### Fixed Income

Fixed income should also provide investment opportunities, although we caution that these are likely to be limited. Under the terms of Mongolia's SBA with the IMF, the government is allowed to return to international capital markets to issue debt from October. A US\$1.2bn bond issuance is currently planned, which will be used to fund infrastructure and support the mining sector, with the yield expected to be between 8 and 11%. High demand may limit returns,

however. The only previous international bond issuance, by the Mongolian Trade and Development Bank back in January 2007, was ten times oversubscribed, with the initial yield price of 9.25% being lowered to 8.75%.

| MAIN PURPOSES   |
|---|
| • Maintaining a stable environment for investors in the Mongolian economy         |
| • Ensuring the right to sell products at market prices, and to repatriate profits |
| • Determine the conditions for investment in Oyu Tolgoi mine                      |
| Areas covered   |
| • Surface and subsoil minerals exploration  |
| • Mining  |
| • Infrastructure  |
| • Mining closure  |
| • Environmental reclamation   |
| Terms of agreement  |
| • Covers 30-year period   |
| • Can be extended for 20 years  |
| • The government will hold 34% of shares in Ivanhoe Mines Mongolia                |

Source: BMI

We believe that the issuance of a dollar bond would present few risks to investors, particularly given that Mongolia's exports generate significant dollar income. In addition, with a new IMF-imposed fiscal law set for parliament in June, we believe that the bond is likely to be targeted at funding new investment, rather than simply as a way to increase discretionary spending. Perhaps the most significant impact will be that the bond will provide a benchmark against which Mongolian firms can borrow on international capital markets, further improving their growth prospects.

## DATA & FORECASTS

**BMI View:** General government revenues reached MNT554.8bn in the first three months of 2010, up 66.2% on the MNT333.9bn posted in the same period of 2009. Meanwhile, expenditures rose

50.6% y-o-y to MNT664.0bn over the same period, bringing the deficit to MNT109.2bn. While revenues are likely to continue rising on the back of a strong macroeconomic recovery in 2010, we believe that the fallout

of the tough 2009-2010 winter is likely to see upward pressure on spending. We forecast a general government deficit of 4.1% of GDP in 2010, down from an estimated 5.7% in 2009.

|   | 2008     | 2009e    |       | Latest Period | 2010f    | 2011f    |
|---|----------|----------|-------|---------------|----------|----------|
| Population, mn [1]                      | 2.6      | 2.7      | -     | -             | 2.7      | 2.7      |
| Nominal GDP, US\$bn [2]                 | 4.9      | 4.0      | -     | -             | 4.7      | 6.0      |
| Real GDP growth, % change y-o-y [2]     | 8.9      | -2.5     | -     | -             | 9.0      | 7.8      |
| Budget balance, % of GDP [3]            | -5.1     | -5.7     | -     | -             | -4.1     | -1.1     |
| Consumer prices, % y-o-y, eop [4]       | 20.7     | 1.8      | 7.7   | Mar           | 7.0      | 10.0     |
| Exchange rate MNT/US\$, eop [5]         | 1,272.00 | 1,430.00 | 1,385 | 4-May         | 1,300.00 | 1,200.00 |
| Goods imports, US\$bn [4]               | 2.0      | 3.1      | 0.6   | Jan-Mar       | 2.1      | 2.7      |
| Goods exports, US\$bn [4]               | 2.0      | 2.5      | 0.5   | Jan-Mar       | 1.8      | 2.5      |
| Balance of trade in goods, US\$bn [4]   | -0.1     | -0.6     | -0.1  | Jan-Mar       | -0.2     | -0.1     |
| Current account, US\$bn [4]             | -0.7     | -0.4     | -     | -             | -0.2     | -0.1     |
| Current account, % of GDP [3]           | -12.0    | -6.6     | -     | -             | -3.8     | -1.9     |
| Foreign reserves ex gold, US\$bn [6]    | 1.5      | 2.1      | -     | -             | 3.3      | 4.0      |
| Total external debt stock, US\$mn [7]   | 1,600.0  | 1,900.0  | -     | -             | 2,000.0  | 2,300.0  |
| Total external debt stock, % of GDP [8] | 32.4     | 47.3     | -     | -             | 42.3     | 38.3     |

Notes: e/f = BMI estimates/forecasts. Sources: 1 IMF/MNSO; 2 IMF/BOM/BMI; 3 BoM/BMI; 4 BoM; 5 BMI; 6 IMF; 7 EBRD; 8 EBRD/BMI.

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